EXPLANATION OF H.R. 1812
("EXPATRIATION TAX ACT OF 1995")

Scheduled for a Markup

By the

HOUSE COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on H.R. 1812 ("Expatriation Tax Act of 1995") on June 13, 1995. H.R. 1812 was introduced by Chairman Archer and Mrs. Johnson on June 9, 1995.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules regarding the tax treatment of expatriation and the provisions of H.R. 1812. Part I is a description of present-law tax rules; and Part II is a description of the provisions of H.R. 1812.

The Subcommittee on Oversight of the House Committee on Ways and Means held a public hearing on March 27, 1995, on the issue of the tax treatment of individuals who relinquish their U.S. citizenship and resident aliens who relinquish their U.S. residency.[2] H.R. 831, as passed by the Senate on March 24, 1995, included a Finance Committee amendment ("Senate amendment") to impose Federal income tax on unrealized gains of individuals who relinquish their U.S. citizenship.[3] The property of such individuals generally would be considered as sold under the Senate amendment, and the net gain subject to U.S. income tax. Net gain on the deemed sale would be taxable under the Senate amendment only to the extent it exceeded $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom expatriate). The Senate amendment was a modification to the Administration proposal included in the President's fiscal year 1996 budget, submitted on February 6, 1995, which would impose income tax on certain unrealized gains of U.S. citizens who relinquish their U.S. citizenship and of certain long-term residents of the United States who relinquish their U.S. residency. The Administration proposal is included as section 201 of H.R. 981 (introduced by Representatives Gephardt and Gibbons, by request, on February 16, 1995) and an identical Senate bill (S. 453).[4]

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[1] This document may be cited as follows: Joint Committee on Taxation, Explanation of H.R. 1812 ("Expatriation Tax Act of 1995") (JCX-26-95), June 13, 1995.

[2] See Joint Committee on Taxation, Background and Issues Relating to Taxation of U.S. Citizens who Relinquish Their Citizenship and Long-Term Resident Aliens Who Relinquish Their U.S. Residency (JCX-16-95), March 23, 1995.

[3] See S. Rept. 104-16, March 20, 1995.

[4] For a description of H.R. 981 and S. 453 ("Tax Compliance Act of 1995"), see Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1996 Budget Proposal (H.R. 980 and H.R. 981 and S. 452 and S. 453) (JCS-5-95), February 17, 1995.

The conference agreement to H.R. 831 did not include the Senate amendment; instead, the conference agreement[5] and the Act[6] included a requirement for the Joint Committee staff to conduct a study of the tax treatment of expatriation and to submit a report to the Chairmen of the House Committee on Ways and Means and the Senate Committee on Finance by June 1, 1995. The Joint Committee staff submitted its report on June 1, 1995,[7] which includes an analysis of present-law tax rules and legislative proposals to modify the tax treatment of expatriation. The Joint Committee staff report also discusses possible alternatives to the existing expatriation proposals, and presents information on other countries' taxation of expatriation and immigration and other countries' taxation of estates, inheritances, and gifts, as well as estimated revenue effects of proposed legislation to impose tax on expatriation.

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[5] See. H. Rept. 104-92, March 29, 1995.

[6] Section 6 of Public Law 104-7, signed by the President on April 11, 1995.

[7] See Joint Committee on Taxation, Issues Presented by Proposals to Modify the Tax Treatment of Expatriation (JCS-17-1995), June 1, 1995. The legislative proposals described and analyzed in the report include the Administration proposal (in H.R. 981 and S. 453), the Senate amendment to H.R. 831, the Gephardt motion to recommit H.R. 1215, and the modified bills introduced by Representative Gibbons (H.R. 1535) and Senator Moynihan (S. 700).

I. PRESENT LAW

A. Taxation of United States Citizens, Residents, and Nonresidents

1. Individual income taxation

a. Income taxation of U.S. citizens and residents

In general

A United States citizen generally is subject to the U.S. individual income tax on his or her worldwide taxable income.[8] All income earned by a U.S. citizen, whether from sources inside or outside the United States, is taxable whether or not the individual lives within the United States. A non-U.S. citizen who resides in the United States generally is taxed in the same manner as a U.S. citizen if the individual meets the definition of a "resident alien," described below.

The taxable income of a U.S. citizen or resident is equal to the taxpayer's total income less certain exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits. When an individual disposes of property, any gain or loss on the disposition is determined by reference to the taxpayer's cost basis in the property, regardless of whether the property was acquired during the period in which the taxpayer was a citizen or resident of the United States.

If a U.S. citizen or resident earns income from sources outside the United States, and that income is subject to foreign income taxes, the individual generally is permitted a foreign tax credit against his or her U.S. income tax liability to the extent of foreign income taxes paid on that income.[9] In addition, a United States citizen who lives and works in a foreign country generally is permitted to exclude up to $70,000 of annual compensation from being subject to U.S. income taxes, and is permitted an exclusion or deduction for certain housing expenses.[10]

Resident aliens

In general, a non-U.S. citizen is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or

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[8] The determination of who is a U.S. citizen for tax purposes, and when such citizenship is lost, is governed by the provisions of the Immigration and Nationality Act, 8 U.S.C. section 1401, et seq. See Treas. Reg. section 1.1-1(c).

[9] See Code sections 901-907.

[10] Section 911.

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time--183 or more days during a 3-year period weighted toward the present year (the "substantial presence test").[11]

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year, the individual generally is not subject to U.S. tax as a resident on account of the substantial presence test. If an individual is present for as many as 183 days during a calendar year, this closer connections/tax home exception will not be available. An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident is not eligible for the closer connections/tax home exception.

For purposes of applying the "substantial presence" test, any days that an individual is present as an "exempt individual" are not counted. Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States, if the individual can establish to the satisfaction of the Secretary of the Treasury that he or she qualifies for this special medical exception.

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) could also be defined as a resident of another country under the internal laws of that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of "tie-breaker" rules to determine the individual's country of residence for income tax purposes. In general, a dual resident individual will be deemed to be a resident of the country in which such individual has a permanent home available to him. If the individual has a permanent home available to him in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., the "center of vital interests." If the country in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either country, he shall be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a citizen. If each country considers him to be its citizen or he is a citizen of neither of them, the competent authorities of the countries are to settle the question of residence by mutual agreement.

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[11] The definitions of resident and nonresident aliens are set forth in Code section 7701(b). The substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. Presence for an average of 122 days (or more) per year over the three-year period would be sufficient to trigger the test.

b. Income taxation of nonresident aliens

Non-U.S. citizens who do not meet the definition of "resident aliens" are considered to be nonresident aliens for tax purposes. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

A nonresident alien is taxed at regular graduated rates on net profits derived from a U.S. business.[12] Nonresident aliens also are taxed at a flat rate of 30 percent on certain types of passive income derived from U.S. sources, although a lower treaty rate may be provided (e.g., dividends are frequently taxed at a reduced rate of 15 percent). Such passive income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income. There is no U.S. tax imposed, however, on interest earned by nonresident aliens with respect to deposits with U.S. banks and certain types of portfolio debt investments.[13] Gains on the sale of stocks or securities issued by U.S. persons generally are <u>not</u> taxable to a nonresident alien because they are considered to be foreign source income.[14]

Nonresident aliens are subject to U.S. income taxation on any gain recognized on the disposition of an interest in U.S. real property.[15] Such gains generally are subject to tax at the same rates that apply to similar income received by U.S. persons. If a U.S. real property interest is acquired from a foreign person, the purchaser generally is required to withhold 10 percent of the amount realized (gross sales price). Alternatively, either party may request that the Internal

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[12] Section 871.

[13] See sections 871(h) and 871(i)(3).

[14] Section 865(a).

[15] Sections 897, 1445, 6039C, and 6652(f), known as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). A USRPHC is any corporation, the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (section 897(c)(2)).

Revenue Service ("IRS") determine the transferor's maximum tax liability and issue a certificate prescribing a reduced amount of withholding (not to exceed the transferor's maximum tax liability).[16]

2. Estate and gift taxation

The United States imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident,[17] whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. No gift tax is imposed, however, on gifts made by nonresident aliens of intangible property having a situs within the United States (e.g., stocks and bonds).[18]

The United States also imposes an estate tax on the worldwide "gross estate" of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death.[19]

Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a U.S. citizen or resident during his or her lifetime and at death. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million.[20] A unified credit of $192,800 is available with respect to taxable transfers by gift and at death. The unified credit effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax.

Residency for purposes of estate and gift taxation is determined under different rules than those applicable for income tax purposes. In general, an individual is considered to be a resident of the United States for estate and gift tax purposes if the individual is "domiciled" in the United States. An individual is domiciled in the United States if the individual (a) is living in the United States and has the intention to remain in the United States indefinitely; or (b) has lived in the United States with such an intention and has not formed the intention to remain indefinitely in another country. In the case of a U.S. citizen who resided in a U.S. possession at the time of

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[16] Section 1445.

[17] Section 2501.

[18] Section 2501(a)(2).

[19] Sections 2001, 2031, 2101, and 2103.

[20] Section 2001(c).

death, if the individual acquired U.S. citizenship solely on account of his birth or residence in a U.S. possession, that individual is not treated as a U.S. citizen or resident for estate tax purposes.[21]

In addition to the estate and gift taxes, a separate transfer tax is imposed on certain "generation-skipping" transfers.

3. Special tax rules with respect to the movement of persons and property into or out of the United States

a. Individuals who relinquish U.S. citizenship with a principal purpose of avoiding U.S. tax

An individual who relinquishes his U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for 10 years after expatriation under section 877 of the Code.[22] Under this provision, if the Treasury Department establishes that it is reasonable to believe that the expatriate's loss of U.S. citizenship would, but for the application of this provision, result in a substantial reduction in U.S. tax based on the expatriate's probable income for the taxable year, then the expatriate has the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. Section 877 does not apply to resident aliens who terminate their U.S. residency.

The alternative method modifies the rules generally applicable to the taxation of nonresident aliens in two ways. First, the expatriate is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident aliens. (Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on any foreign source income.) Second, the scope of items treated as U.S. source income for section 877 purposes is broader than those items generally considered to be U.S. source income under the Code. For example, gains on the sale of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S. source income under the Code. However, if an individual is subject to the alternative taxing method of section 877, such gains are treated as U.S. source income with

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[21] Section 2209.

[22] Treasury regulations provide that an individual's citizenship status is governed by the provisions of the Immigration and Nationality Act, specifically referring to the "rules governing loss of citizenship [set forth in] sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489)." Treas. Reg. section 1.1-1(c). Under the Immigration and Nationality Act, an individual is generally considered to lose U.S. citizenship on the date that an expatriating act is committed. The present law rules governing the loss of citizenship, and a description of the types of expatriating acts that lead to a loss of citizenship, are discussed more fully in Part B.1., below.

respect to that individual. The alternative method applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien.

Because section 877 alters the sourcing rules generally used to determine the country having primary taxing jurisdiction over certain items of income, there is an increased potential for such items to be subject to double taxation. For example, a former U.S. citizen subject to the section 877 rules may have capital gains derived from stock in a U.S. corporation. Under section 877, such gains are treated as U.S. source income, and are, therefore, subject to U.S. tax. Under the internal laws of the individual's new country of residence, however, that country may provide that all capital gains realized by a resident of that country are subject to taxation in that country, and thus the individual's gain from the sale of U.S. stock also would be taxable in his country of residence. If the individual's new country of residence has an income tax treaty with the United States, the treaty may provide for the amelioration of this potential double tax.

Similar rules apply in the context of estate and gift taxation if the transferor relinquished U.S. citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer. A special rule is applied to the estate tax treatment of any decedent who relinquished his U.S. citizenship within 10 years of death, if the decedent's loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.[23] Once the Secretary of the Treasury establishes a reasonable belief that the expatriate's loss of U.S. citizenship would result in a substantial reduction in estate, inheritance, legacy and succession taxes, the burden of proving that one of the principal purposes of the loss of U.S. citizenship was not avoidance of U.S. income or estate tax is on the executor of the decedent's estate.

In general, the estates of such individuals are taxed in accordance with the rules generally applicable to the estates of nonresident aliens (i.e., the gross estate includes all U.S.-situs property held by the decedent at death, is subject to U.S. estate tax at the rates generally applicable to the estates of U.S. citizens, and is allowed a unified credit of $13,000, as well as credits for State death taxes, gift taxes, and prior transfers). However, a special rule provides that the individual's gross estate also includes his pro-rata share of any U.S.-situs property held through a foreign corporation in which the decedent had a 10-percent or greater voting interest, provided that the decedent and related parties together owned more than 50 percent of the voting power of the corporation. Similarly, gifts of intangible property having a situs within the United States (e.g., stocks and bonds) made by a nonresident alien who relinquished his U.S. citizenship within the 10-year period ending on the date of transfer are subject to U.S. gift tax, if the loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.[24]

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[23] Section 2107.

[24] Section 2501(a)(3).

b. Aliens having a break in residency status

A special rule applies in the case of an individual who has been treated as a resident of the United States for at least three consecutive years, if the individual becomes a nonresident but regains residency status within a three-year period.[25] In such cases, the individual is subject to U.S. tax for all intermediate years under the section 877 rules described above (i.e., the individual is taxed in the same manner as a U.S. citizen who renounced U.S. citizenship with a principal purpose of avoiding U.S. taxes). The special rule for a break in residency status applies regardless of the subjective intent of the individual.

c. Transfers to foreign corporations

Certain transfers of property by shareholders to a controlled corporation are generally tax-free if the persons transferring the property own at least 80 percent of the corporation after the transfer.[26] Also, in certain corporate reorganizations, including qualifying acquisitions and dispositions, shareholders of one corporation may exchange their stock or securities for stock or securities of another corporation that is a party to the reorganization without a taxable event except to the extent they receive cash or other property that is not permitted stock or securities. In these cases, a corporation may also transfer property to another corporation that is a party to the reorganization, without a taxable event except to the extent of certain non-permitted consideration.[27] A liquidation of an 80-percent owned corporate subsidiary into its parent corporation is also generally tax-free[28].

Under the rules applicable to these types of transfers, property transferred to a corporation retains its basis, to the extent the transfer was tax-free, so that any appreciation (i.e., built in gain) will be subject to tax if the property is subsequently sold by the recipient corporation. Similarly, a shareholder who exchanges stock of one corporation for stock of another retains his original basis so that a subsequent sale of the acquired stock can produce a taxable gain.

Section 367 applies special rules, however, if property is transferred by a U.S. person to a foreign corporation in a transaction that would otherwise be tax-free under these provisions. These special rules are generally directed at situations where property is transferred to a foreign corporation, outside of the U.S. taxing jurisdiction, so that a subsequent sale by that corporation could escape U.S. tax notwithstanding the carryover basis of the asset. In some instances, such a

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[25] Section 7701(b)(10).

[26] Section 351.

[27] Sections 368, 354, 356, and 361. (See also section 355.)

[28] Section 332.

transfer causes an immediate taxable event so that the generally applicable tax-free rules are overridden. In other instances, the taxpayer may escape immediate tax by entering a gain recognition agreement ("GRA") obligating the taxpayer to pay tax if the property is disposed of within a specified time period after the transfer. The GRA rules generally require the taxpayer to agree to file an amended return for the year of the original transfer if the property is disposed of by the transferee (including payment of interest from the due date of the return for the year of the original transfer to the time the additional tax under the agreement is actually paid following the disposition).

Section 367 also imposes rules directed at situations where a U.S. person has an interest in a foreign corporation, such as a controlled foreign corporation ("CFC") meeting specific U.S. shareholder ownership requirements, that could result in the U.S. person being taxed on its share of certain foreign corporate earnings. These rules are designed to prevent the avoidance of tax in circumstances where a reorganization or other nonrecognition transaction restructures the stock or asset ownership of the foreign corporation so that the technical requirements for imposition of U.S. tax on foreign earnings under the CFC or other rules are no longer met, so that there is potential for removing the earnings of the original CFC from current or future U.S. tax, or changing the character of the earnings for U.S. tax purposes (e.g. from dividend to capital gain).

The rules of section 367 do not generally apply unless there is a transfer by a U.S. person to a foreign corporation, or unless a foreign corporation of which a U.S. person is a shareholder engages in certain transactions. Because an individual who expatriates is no longer a U.S. person, section 367 has no effect on actions taken by such individuals after expatriation. The Treasury Department has considerable regulatory authority under section 367 to address situations that may result in U.S. tax avoidance. For example, section 367(b) provides that any of certain tax-free corporate transactions that do not involve a transfer of property from a U.S. person (described in section 367(a)(1)) can be recharacterized as taxable "to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes." The legislative history of this provision suggests that it was directed principally at situations involving avoidance of U.S. tax on foreign earnings and profits;[29] however the statutory language is quite broad and was provided in conjunction with the general rules taxing certain transfers by U.S. persons. Under the existing section 367 regulations and the relevant expatriation sections of the Code, a U.S. person who expatriates, even for a principal purpose of avoiding U.S. tax, may subsequently engage in transactions that involve the transfer of property to a foreign corporation without any adverse consequences under section 367, since expatriation (even for a principal purpose of tax avoidance) is not an event covered by section 367 or the current regulations under that section. Similarly, a U.S. person who has expatriated would not be considered a U.S. shareholder for purposes of applying the rules that address restructurings of foreign corporations with U.S. shareholders. By engaging in such a transaction, a taxpayer

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[29] See, e.g., H.Rept. No. 94-658 pp 239-248 (94th Cong. 1st Sess, 1975); S.Rept. No. 94-938, pp. 261-271 (94th Cong., 2d Sess, 1976); H. Rept. No. 94-1515, p. 463 (94th Cong., 2d Sess., 1976)

that has expatriated could transfer assets that would otherwise generate income which would be subject to tax under section 877 into a foreign corporation, thus transforming the income into non-U.S. source income not subject to tax under section 877. For example, under section 877, if a principal purpose of tax avoidance existed, an expatriate would be taxed for 10 years on any sale of U.S. corporate stock. However, after expatriation, the person would no longer be a U.S. person for purposes of section 367, and thus could transfer U.S. corporate stock to a foreign corporation controlled by the expatriate under section 351 without any section 367 effect. The foreign corporation could then sell the U.S. corporate stock within the 10 year period, but the gain would not be subject to U.S. tax.

In addition, the IRS or Treasury might encounter difficulties enforcing a gain recognition agreement if a U.S. person who has entered into such an agreement to pay tax on a later disposition of an asset subject to the agreement and then expatriates. The gain recognition agreement regulations contain provisions requiring security arrangements if a U.S. natural person who has entered an agreement dies (or if a U.S. entity goes out of existence) but these provisions do not apply if a U.S. natural person expatriates. [30]

Even if an individual is subject to the alternative taxing method of section 877 (because the person expatriated with a principal purpose of avoiding U.S. tax), section 877 does not impose a tax on foreign source income. Thus, such an individual could expatriate and subsequently transfer appreciated property to a foreign corporation or other entity beyond the U.S. taxing jurisdiction, without any U.S. tax being imposed on the appreciation under section 877.

Similar issues exist under section 1491 of the Code. Section 1491 imposes a 35-percent tax on otherwise untaxed appreciation when appreciated property is transferred by a U.S. citizen or resident, or by a domestic corporation, partnership, estate or trust, to certain foreign entities in a transaction not covered by section 367. In some cases, taxpayers may elect to enter into a gain recognition agreement (rather than pay immediate tax) pursuant to section 1492.[31] As in the case of section 367, an individual who has expatriated is no longer a U.S. citizen and may also no longer be a U.S. resident, thus a transfer by such a person would be unaffected by section 1491.

B. Requirements for United States Citizenship, Immigration, and Visas

1. United States citizenship

An individual may acquire U.S. citizenship in one of three ways: (1) being born within the geographical boundaries of the United States; (2) being born outside the United States to at least

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[30] See, e.g., Temp. Reg. section 1.367(a)-3T(g)(9) and (10), Notice 87-85, 1987-2 C.B. 395.

[31] See, e.g., PLR 91-03033.

one U.S. citizen parent (as long as that parent had previously been resident in the United States for a requisite period of time); or (3) through the naturalization process. All U.S. citizens are required to pay U.S. income taxes on their worldwide income. The State Department estimates that there are approximately 3 million U.S. citizens living abroad, although thousands of these individuals may not even know that they are U.S. citizens.

A U.S. citizen may voluntarily give up his or her U.S. citizenship at any time by performing one of the following acts ("expatriating acts") with the intention of relinquishing U.S. nationality: (1) becoming naturalized in another country; (2) formally declaring allegiance to another country; (3) serving in a foreign army; (4) serving in certain types of foreign government employment; (5) making a formal renunciation of nationality before a U.S. diplomatic or consular officer in a foreign country; (6) making a formal renunciation of nationality in the United States during a time of war; or, (7) committing an act of treason.[32] An individual who wishes to formally renounce citizenship (item (5), above), must execute an Oath of Renunciation before a consular officer, and the individual's loss of citizenship is effective on the date the oath is executed. In all other cases, the loss of citizenship is effective on the date that the expatriating act is committed, even though the loss may not be documented until a later date. The State Department generally documents loss in such cases when the individual acknowledges to a consular officer that the act was taken with the requisite intent. In all cases, the consular officer abroad submits a certificate of loss of nationality ("CLN") to the State Department in Washington, D.C. for approval.[33] Upon approval, a copy of the CLN is issued to the affected individual. The date upon which the CLN is approved is not the effective date for loss of citizenship.

Before a CLN is issued, the State Department reviews the individual's files to confirm that (1) the individual was a U.S. citizen; (2) an expatriating act has been committed; (3) the act was undertaken voluntarily; and (4) the individual had the intent of relinquishing citizenship when the expatriating act was committed. If the expatriating act involved an action of a foreign government (for example, if the individual was naturalized in a foreign country or joined a foreign army), the State Department will not issue a CLN until it has obtained an official statement from the foreign government confirming the expatriating act. If a CLN is not issued because the State Department does not believe that an expatriating act has occurred (for example, if the requisite intent appears to be lacking), the issue is likely to be resolved through litigation. Whenever the loss of U.S. nationality is put in issue, the burden of proof is on the person or party claiming that a loss of citizenship has occurred to establish, by a preponderance of the evidence, that the loss occurred. 8 U.S.C. sec. 1481(b). Similarly, if a CLN has been issued, but the State Department later discovers that such issuance was improper (for example, because fraudulent documentation was submitted, or the requisite intent appears to be lacking), the State Department could initiate proceedings to revoke the CLN. If the recipient is unable to establish beyond a preponderance of the evidence that citizenship was lost on the date claimed, the CLN would be revoked. To the

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[32] 8 U.S.C. section 1481.

[33] 8 U.S.C. section 1501.

extent that the IRS believes a CLN was improperly issued, the IRS could present such evidence to the State Department and request that revocation proceedings be commenced. If it is determined that the individual has indeed committed an expatriating act, the date for loss of citizenship will be the date of the expatriating act.

A child under the age of 18 cannot lose U.S. citizenship by naturalizing in a foreign state or by taking an oath of allegiance to a foreign state. A child under 18 can, however, lose U.S. citizenship by serving in a foreign military or by formally renouncing citizenship, but such individuals may regain their citizenship by asserting a claim of citizenship before reaching the age of eighteen years and six months.

A naturalized U.S. citizen can have his or her citizenship involuntarily revoked if a U.S. court determines that the certificate of naturalization was illegally procured, or was procured by concealment of a material fact or by willful misrepresentation (for example, if the individual concealed the fact that he served as a concentration camp guard during World War II).[34] In such cases, the individual's certificate of naturalization is cancelled, effective as of the original date of the certificate; in other words, it is as if the individual were never a U.S. citizen at all.

2. United States immigration and visas

In general, a non-U.S. citizen who enters the United States is required to obtain a visa.[35] An immigrant visa (also known as a "green card") is issued to an individual who intends to relocate to the United States permanently. Various types of nonimmigrant visas are issued to individuals who come to the United States on a temporary basis and intend to return home after a certain period of time. The type of nonimmigrant visa issued to such individuals is dependent upon the purpose of the visit and its duration. An individual holding a nonimmigrant visa is prohibited from engaging in activities that are inconsistent with the purpose of the visa (for example, an individual holding a tourist visa is not permitted to obtain employment in the United States).

Foreign business people and investors often obtain "E" visas to come into the United States. Generally, an "E" visa is initially granted for a one-year period, but it can be routinely extended for additional two-year periods. There is no overall limit on the amount of time an individual may retain an "E" visa. There are two types of "E" visas: an "E-1" visa, for "treaty

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[34] See section 340(a) of the Immigration and Nationality Act, 8 U.S.C. section 1451(a). See also, U.S. v. Demjanjuk, 680 F.2d 32, cert. denied, 459 U.S. 1036 (1982).

[35] Under the Visa Waiver Pilot Program, nationals of most European countries are not required to obtain a visa to enter the United States if they are coming as tourists and staying a maximum of 90 days. Also, citizens of Canada, Mexico, and certain islands in close proximity to the United States do not need visas to enter the United States, although other types of travel documents may be required.

traders" and an "E-2" visa, for "treaty investors". To qualify for an "E-1" visa, an individual must be a national of a country that has a treaty of trade with the United States, and must be coming to the United States solely to engage in substantial trade principally between the U.S. and that country. Trade includes the import and export of goods or services. At least 50 percent of the foreign-based company must be owned by nationals of that country, and at least 50 percent of the shareholders must either live abroad, or have an "E-1" visa and live in the United States (thus, an individual holding a "green card" would not be counted). Over 50 percent of the individual's business must be between the U.S. and the foreign company. To qualify for an "E-2" visa, an individual (or a company of which he is an executive, manager, or essential employee) must be a national of a country that has a treaty investor agreement with the United States, and must be coming to the United States solely to develop and direct the operations of an enterprise in which he has invested, or is actively in the process of investing, a substantial amount of capital.

3. Relinquishment of green cards

There are several ways in which a green card can be relinquished. First, an individual who wishes to terminate his or her permanent residency may simply mail his or her green card back to the INS. Second, an individual may be involuntarily deported from the United States (through a judicial or administrative proceeding), and the green card must be relinquished at that time. Third, a green card holder who leaves the United States and attempts to re-enter more than a year later may have his or her green card taken away by the INS border examiner, although the individual may appeal to an immigration judge to have the green card reinstated. A green card holder may permanently leave the United States without relinquishing his or her green card, although such individuals would continue to be taxed as U.S. residents.[36]

[36] Code section 7701(b)(6)(B) provides that an individual who has obtained the status of residing permanently in the United States as an immigrant (i.e., an individual who has obtained a green card) will continue to be taxed as a lawful permanent resident of the United States until such status is revoked, or is administratively or judicially determined to have been abandoned.

II. EXPLANATION OF H.R. 1812

Overview

In general, the bill would substantially strengthen the present-law expatriation tax provisions (secs. 877, 2107, and 2501(a)(3)) in two principal respects. First, the bill would subject certain individuals to the expatriation tax provisions without inquiry as to their motive for losing their U.S. citizenship and would require other individuals to request a ruling from the Secretary of the Treasury as to whether the loss of citizenship had a principal purpose of tax avoidance. Second, the bill would expand the categories of income and gains that are treated as U.S. source (and therefore subject to U.S. income tax under section 877) if earned by an individual who is subject to the expatriation tax provisions.

As under present law, the expatriation tax provisions would continue to be applicable for the 10-year period following the loss of citizenship. The date of an individual's loss of citizenship would for tax purposes continue to be determined in accordance with the Immigration and Nationality Act (i.e., the date of loss of citizenship would be the date the individual commits an expatriating act).

In addition, the bill includes provisions designed to eliminate the ability to engage in certain transactions currently available to partially or completely circumvent the 10-year reach of section 877 under current law. Finally, the bill would provide relief from double taxation in circumstances where another country also taxes the same items that would otherwise be subject to tax under the expatriation tax provisions.

Individuals covered

The present-law expatriation tax provisions apply to any individual who loses his or her U.S. citizenship unless such loss did not have as a principal purpose the avoidance of taxes. Under the bill, any U.S. citizen who loses his or her citizenship would generally be treated as having lost such citizenship with a principal purpose of the avoidance of taxes if either: (a) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of such loss is greater than $100,000 (the "tax liability test"), or (b) the individual's net worth as of the date of such loss is $500,000 or more (the "net worth test"). The dollar amount thresholds contained in the tax liability test and the net worth test would be indexed for inflation in the case of a loss of citizenship occurring in any calendar year after 1996. An individual who does not satisfy either the tax liability test or the net worth test would, as under present law, be subject to the expatriation tax provisions unless the individual's loss of citizenship did not have as a principal purpose the avoidance of tax.

An individual who satisfies either the tax liability test or the net worth test would not be subject to the expatriation tax provisions if such individual can demonstrate that he or she did not

have a principal purpose of tax avoidance and the individual is within one of the following categories: (a) the individual was born with dual citizenship and retains only the non-U.S. citizenship; (b) the individual becomes a citizen of the country in which the individual, the individual's spouse, or one of the individual's parents, was born; (c) the individual was present in the United States for no more than 30 days during any year in the 10-year period immediately preceding the date of his or her loss of citizenship; (d) the individual relinquishes his or her citizenship before reaching age 18-1/2; or (e) any other category of individuals prescribed by Treasury regulations. In order to qualify for this exception, the individual must, within 1 year from the date of loss of citizenship, submit a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as 1 of its principal purposes the avoidance of taxes.

Items subject to section 877

Section 877 presently recharacterizes as U.S. source income certain gains of individuals who are subject to the expatriation tax provisions, thereby subjecting such individuals to U.S. income tax on such gains. The bill would extend this recharacterization to income and gains derived from property obtained in certain transactions on which gain or loss would not ordinarily be recognized. An individual covered by section 877 who exchanges property that would produce U.S. source income for property that would produce foreign source income would be required to recognize immediately as U.S. source income any gain on such exchange (determined as if the property had been sold for its fair market value on such date). However, this rule requiring immediate gain recognition would not apply if the individual enters into an agreement with the Secretary of the Treasury specifying that any income or gains derived from the property acquired in the exchange during the 10-year period after the loss of citizenship would be treated as U.S. source income. Such a gain recognition agreement would terminate if the property transferred in the exchange is disposed of by the acquiror, and any gain that had not been recognized by reason of such agreement would be recognized as U.S. source income as of such date. The Secretary of Treasury would be authorized to issue regulations providing similar treatment for nonrecognition transactions that occur within 5 years immediately prior to the date of loss of citizenship.

In addition, the bill would extend the recharacterization of section 877 to treat as U.S. source any income and gains derived from stock in a foreign corporation that is more than 50 percent owned, directly or indirectly, by the individual losing citizenship on the date of such loss or at any time during the 2 years preceding such loss. Such income and gains would be recharacterized as U.S. source only to the extent of the amount of earnings and profits accrued prior to the date of loss of citizenship and while such ownership requirement is satisfied.

Special rule for shift in risks of ownership

Section 877 applies to income and gains for the 10-year period following the loss of citizenship. For purposes of applying section 877, the bill would suspend this 10-year period for

gains derived from a particular asset during any period in which the individual's risk of loss with respect to such asset is substantially diminished.

Double tax relief

In order to avoid double taxation for individuals subject to the expatriation tax provisions, the bill would provide a credit against the U.S. tax imposed under the expatriation tax provisions for any foreign income, gift, estate or similar taxes paid with respect to the items subject to such taxation. This credit would be available only against the tax imposed solely as a result of the expatriation tax provisions, and would not be available to be used to offset any other U.S. tax liability.

Effect on tax treaties

It is intended that the purpose of the expatriation tax provisions, as amended by this bill, would not be defeated by any contrary treaty provision. However, the Treasury Department would be directed to review all outstanding treaties to determine whether the expatriation tax provisions, as revised, would conflict with treaty provisions and to eliminate any such conflicts through renegotiation of the affected treaties as necessary. Beginning on the tenth anniversary of the enactment of the provision, any conflicting treaty provisions that remain in force would take precedence over the expatriation tax provisions as revised.

Required information sharing

The State Department would be required to collect relevant information from individuals who lose citizenship, including the social security numbers, forwarding foreign addresses, new country of residence and citizenship and, in the case of individuals with a net worth of at least $500,000, a balance sheet. Such information would be required to be provided routinely to the IRS. An individual's failure to provide the required information would result in the imposition of a penalty for each year the failure continues equal to the greater of (a) 5 percent of the individual's expatriation tax liability for such year, or (b) $1,000.

Treasury report

The Treasury Department would be directed to undertake a study on the compliance of U.S. citizens and green-card holders residing outside the United States with tax return responsibilities and to make recommendations regarding the improvement of such compliance. The findings of such study and such recommendations would be required to be reported to the House Committee on Ways and Means and the Senate Committee on Finance within 90 days of the date of enactment.

During the course of the Joint Committee's study, an issue was identified regarding the difficulty in determining when a U.S. citizen has committed an expatriating act with the requisite

intent, and thus no longer has the obligation to continue to pay U.S. taxes on his or her worldwide income due to the fact that the individual is no longer a U.S. citizen. Neither the Immigration and Nationality Act nor any other federal law requires an individual to request a CLN within a specified amount of time after an expatriating act has been committed, even though the expatriating act terminates the status of the individual as a U.S. citizen for all purposes, including the status of being subject to U.S. tax on world wide income. Accordingly, it is anticipated that the Treasury report, in evaluating whether improved coordination between executive branch agencies could improve compliance with the requirements of the Internal Revenue Code, will review the process through which the State Department determines when citizenship has been lost, and make recommendations regarding changes to such process to recognize the importance of such date for tax purposes. In particular, it is anticipated that the Treasury Department will explore ways of working with the State Department to insure that the State Department will not issue a CLN confirming the commission of an expatriating act with the requisite intent necessary to terminate citizenship in the absence of adequate evidence of both the occurrence of the expatriating act (e.g., the joining of a foreign army) and the existence of the requisite intent.

Effective date

The bill generally would apply to any individual who loses U.S. citizenship on or after February 6, 1995. The determination of the date of loss of citizenship would remain the same as under present law (i.e., the date of loss of citizenship would be the date of the expatriating act). However, a special transition rule would apply to individuals who committed an expatriating act within one year prior to February 6, 1995, but had not applied for a CLN as of such date. Such an individual would be subject to the expatriation tax provisions as amended by the bill as of the date of application for the CLN, but would not be retroactively liable for U.S. income taxes on his or her worldwide income. In order to qualify for the exception provided for individuals who fall within one of the specified categories, such individual would be required to submit a ruling request within 1 year after the date of enactment of the bill.

The special transition rule is illustrated with the following example. Mr. A joined a foreign army on October 1, 1994 with the intent to relinquish his U.S. citizenship, but Mr. A does not apply for a CLN until October 1, 1995. Mr. A would be subject to the expatriation tax provisions (as amended) for the 10-year period beginning on October 1, 1995. Moreover, if Mr. A falls within one of the specified categories (i.e., Mr. A is age 18), in order to qualify for the exception provided for such individuals, Mr. A would be required to submit his ruling request within 1 year after the date of enactment of the bill. Mr. A would not, however, be liable for U.S. income taxes on his worldwide income for any period after October 1, 1994.